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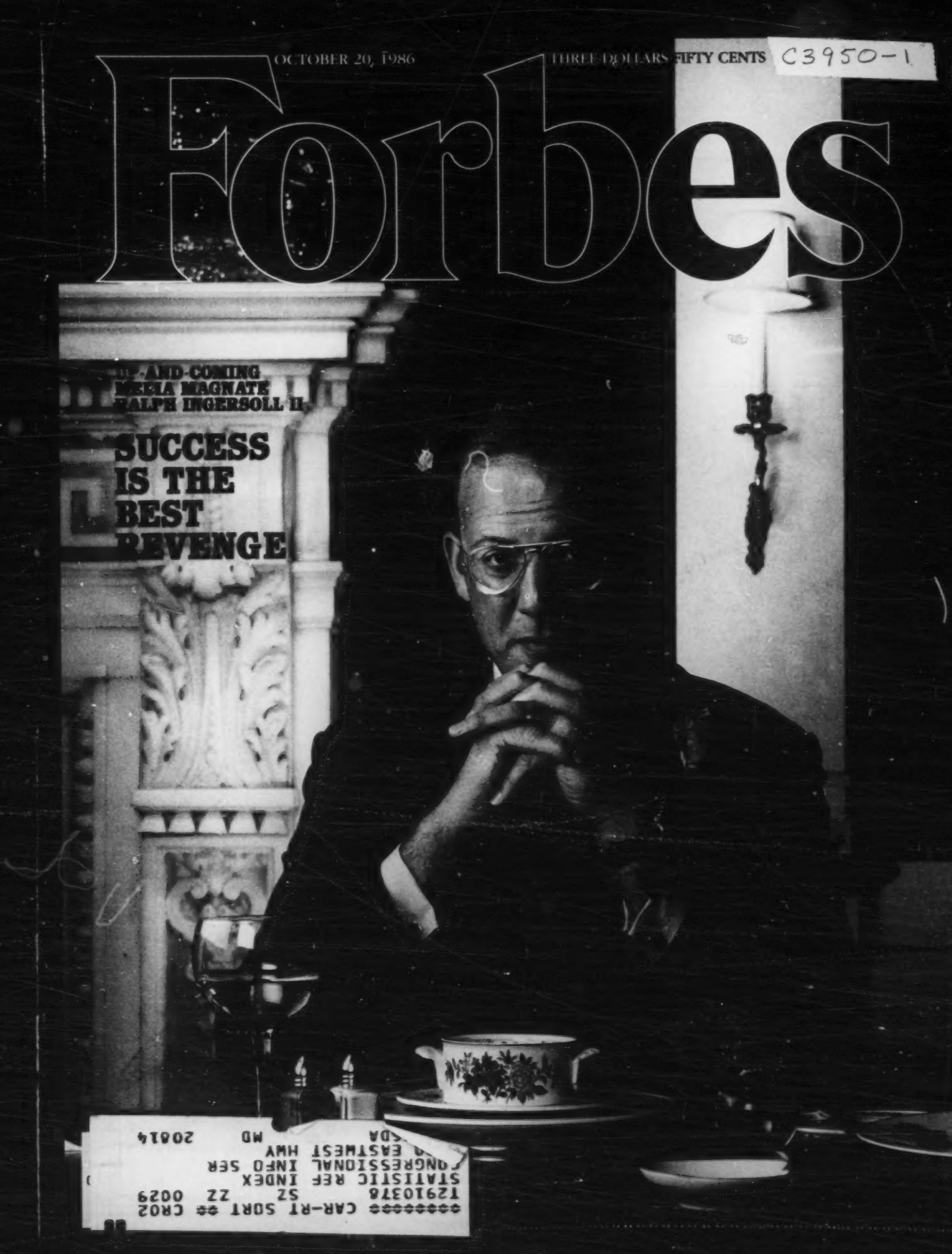

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Forbes

OCTOBER 20, 1986
VOLUME 138
NUMBER 8

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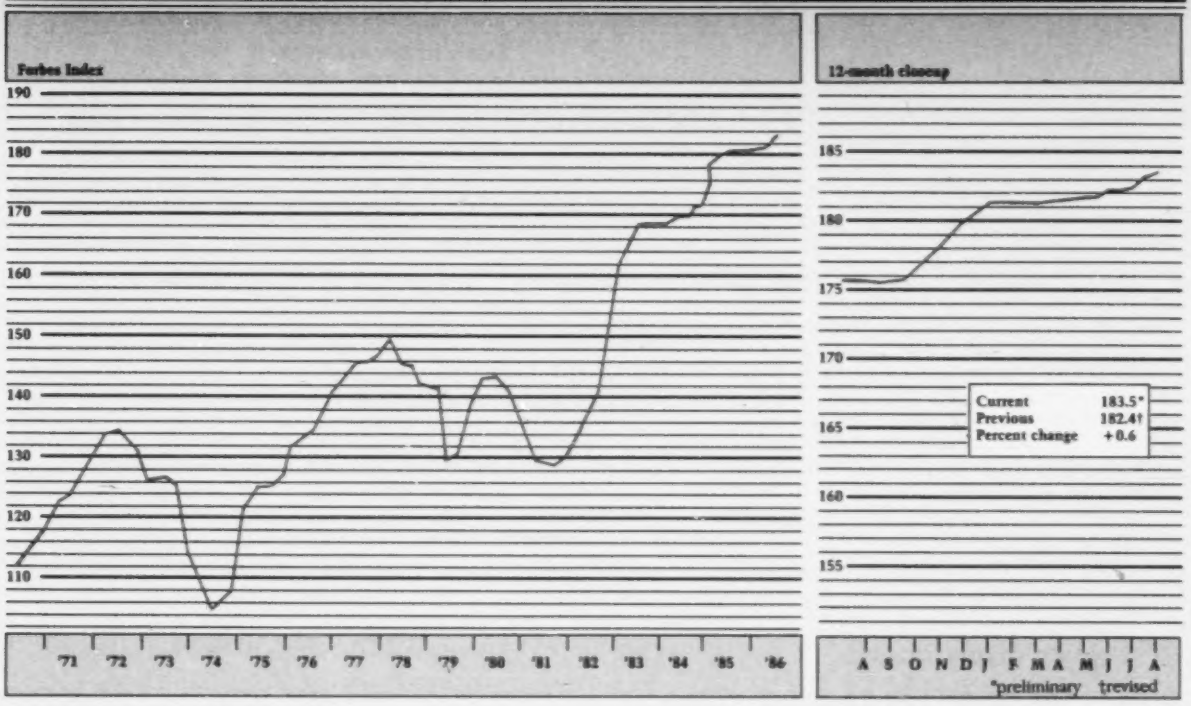
The Forbes Index



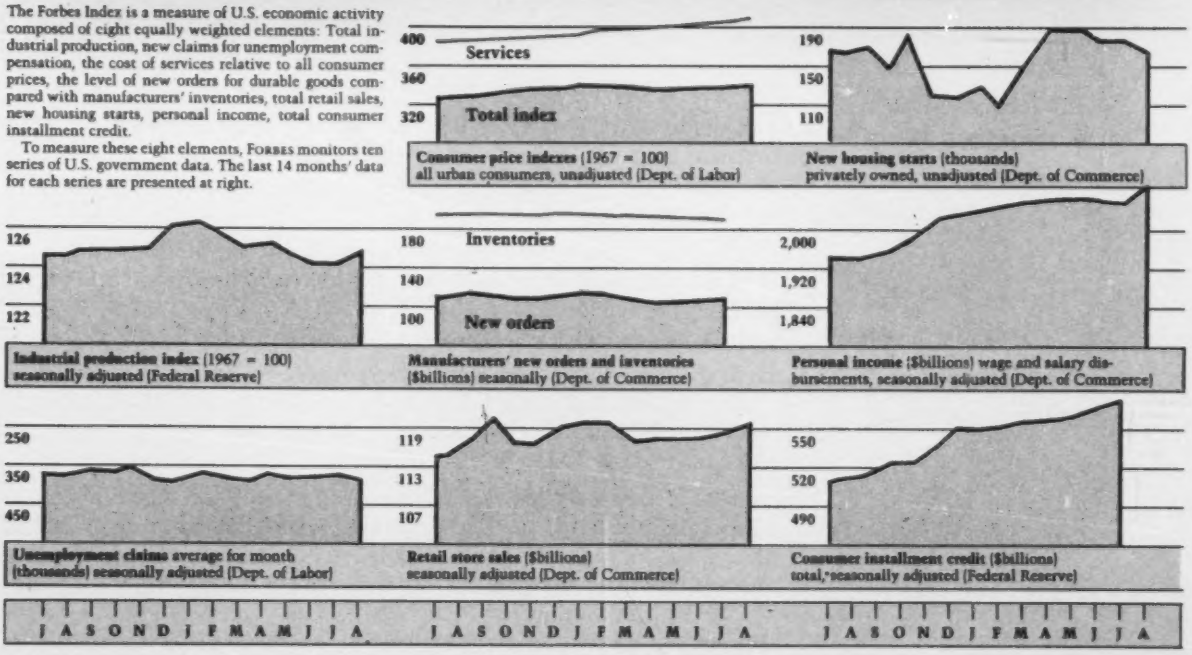
Fuel for the fire. Personal income rose 0.6% in August, the largest monthly increase since November of last year. This increase should add even more strength to already strong consumer spending. This helped The Forbes Index rachet upward 0.6% during the latest reporting period, the sharpest month-to-month gain in seven months.

Manufacturing remains weak. Industrial production, despite a 0.2% increase from July to August, is 0.3% below a year ago. The Consumer Price Index, up a modest 0.2% in August, is up 3.7% since the beginning of the year. But the Fed will surely monitor response to the new tax code before reducing the discount rate.

The Forbes Index Components

The Forbes Index is a measure of U.S. economic activity composed of eight equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, the level of new orders for durable goods compared with manufacturers' inventories, total retail sales, new housing starts, personal income, total consumer installment credit.

To measure these eight elements, FORBES monitors ten series of U.S. government data. The last 14 months' data for each series are presented at right.



Scarred by the games many S&Ls have played with mortgage fee income, the FASB intends to change the rules. It's about time.

Party pooping

By John R. Hayes

WHEN IT COMES TO spoiling parties, nobody does it quite like an august body of accountants. Just ask the country's savings and loan executives. Their world has been looking up lately. With interest rates falling, something like $300 billion or $400 billion of home mortgages will be written this year, with the thrifts originating half of them. On nearly all that volume, borrowers will have to pay the lenders origination fees—"points" in the vernacular—and sundry closing expenses. Payable up front. One point on $300 billion is $3 billion. Taking points into income as they are paid has helped many a thrift—Financial Corp. of America, to take one notable case (FORBES, *July 30, 1984*)—report healthy profits even as it was going down the tubes.

Come now the accountants to throw cold water on the points game. Last December the Financial Accounting Standards Board released an exposure draft that would force S&Ls to amortize fee income over the life of the mortgage. The way the rules are written, on a 30-year, $100,000 mortgage that generates, say, $3,000 in upfront fees, the lender would be able to book as income only $56 of the points annually, as long as the loan is outstanding. Only if the loan were prepaid or sold could the fees be recognized earlier. Under current Federal Home Loan Bank Board rules, S&Ls may book up to 2 points plus $400 as revenue when the loan closes.

The lenders, of course, are up in arms. In response to its exposure draft, the FASB has received nearly 1,000 letters all told, most of them opposed. Brian Smith, associate director of research for the U.S. League of Savings Institutions, estimates that if deferring fee income becomes the generally accepted accounting practice, reported profits will be cut by "as much as 70%." Many other thrifts that have been reporting profits would immediately begin reporting losses.

The thrift executives' defense of the status quo? In essence, they argue that writing a mortgage is one business, while earning interest on a mortgage is another business. Who cares if the two businesses are operated by the same people, beneath the same roof? As Smith puts the case: "The entire mortgage banking business is substantial testimony to the fact that you can divorce the [mortgage] origination function from the funds-providing function."

Does that rationale sound a little strained? It does to many practicing accountants.

"The borrower doesn't want a separate service," retorts John Stewart, partner with Big Eight accountants Arthur Andersen & Co. "He wants the loan. He doesn't want his home appraised just to have it appraised. He wants it appraised so he can buy it." Lenders' fees, Stewart is saying, are a part of what the borrower must pay to rent the lender's money and should therefore be taken into income over the life of a loan, as is interest. This makes good accounting sense. And by limiting a thrift's ability to slap a lot of low-interest mortgages on the books while reporting profits derived from making the risky loans, the FASB's rules would make it difficult for thrifts' income statements to thrive while their balance sheets rot.

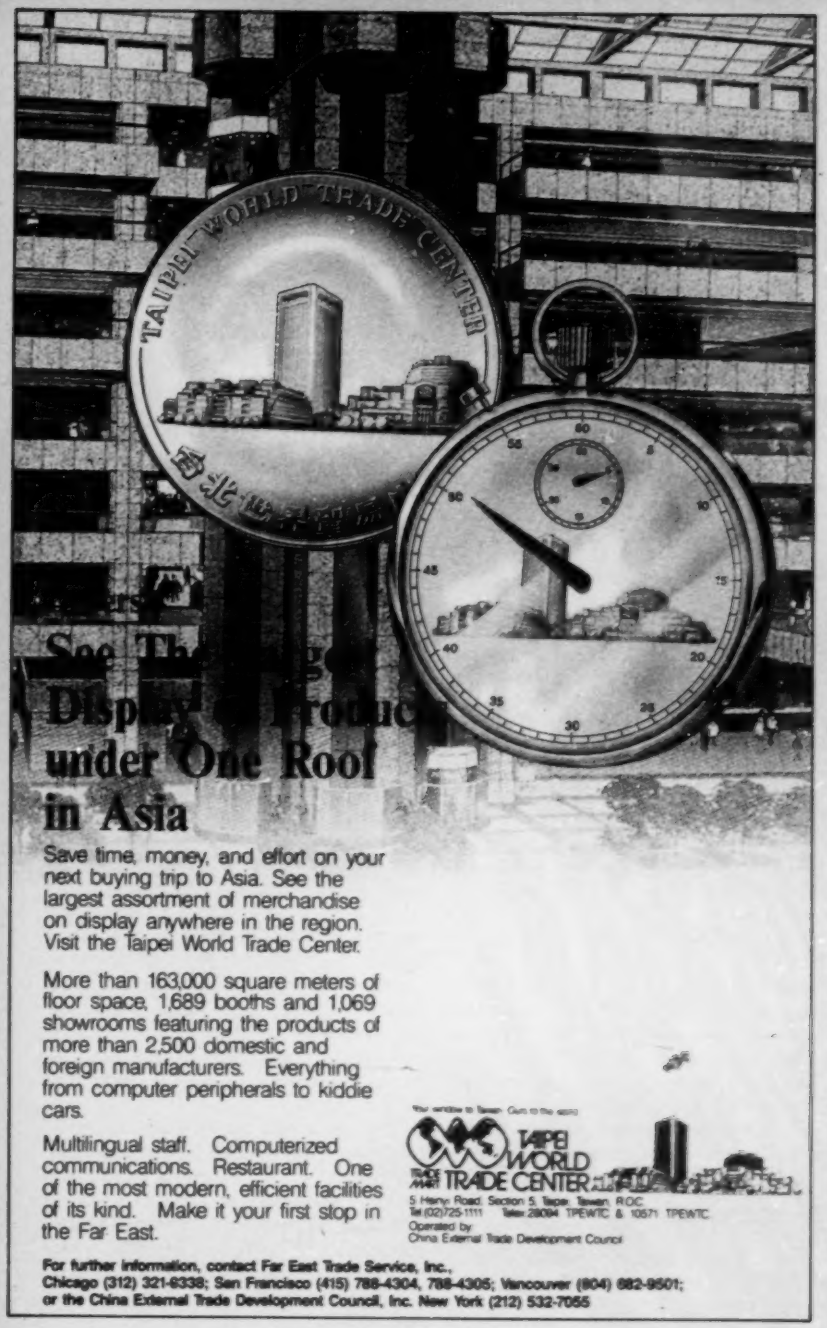
Some thrift managers have brought out an old chestnut: that now more than ever the beleaguered thrifts need to report all the income they can. Otherwise investors will continue to

Earnings kickers

Most big thrifts already defer some origination fees. But new accounting rules won't help earnings and will probably hurt.

Holding company (headquarters)	Assets (millions)	Total revenues (millions)	Loan origination fees (millions)	Pretax operating income (millions)
Financial Corp of America (Irvine, Calif)	$27,375	$3,344	$40.9	$63.2
HF Ahmanson & Co (Los Angeles)	27,229	3,029	46.1	351.7
Great Western Fin Corp (Beverly Hills)	25,471	3,404	67.8	335.4
CalFed Inc (Los Angeles)	19,005	2,275	47.0	188.1
Meritor Financial Group (Philadelphia)	17,153	1,729	46.2	71.8
GlenFed Inc[1] (Glendale, Calif)	16,387	1,397	60.4	112.0
Golden West Financial Corp (Oakland)	12,130	1,378	21.6	242.7
First Federal of Michigan (Detroit)	10,196	1,115	10.5	79.9
Home Federal (San Diego)	10,019	1,148	46.8	117.2
Gibraltar Financial Corp (Beverly Hills)	9,862	1,136	30.3	61.8

Data for fiscal year 1985 except where noted. [1]Fiscal year ending 6/30/86.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REACH THE AFFLUENT IN FORBES

One out of every 3.5 FORBES subscribers is a millionaire

Source: Don Bowdren Associates, 1985

steer capital elsewhere. This was behind the Federal Home Loan Bank Board's 1980 decision to allow the S&Ls to take more fee income into earnings than was previously allowed.

"Those arguments are completely irrelevant," replies Peter Horoszko, manager of the FASB's loan fees project. "The board is here for the purpose of improving financial reporting, and if it tells you your baby's ugly, then your baby's ugly."

Some major thrifts, including many in the table on page 97, already defer a considerable amount of fee income and will be hurt less than more agressive thrifts. Even these, however, are hoping the accountants will relax other proposals in the exposure draft.

Take costs. The FASB's draft would require lenders to expense, immediately, all the costs of making a loan. But expensing the costs of making

"The board is here for the purpose of improving financial reporting, and if it tells you your baby's ugly, then your baby's ugly."

mortgages while capitalizing fee income strikes many S&L executives as inconsistent and unfair.

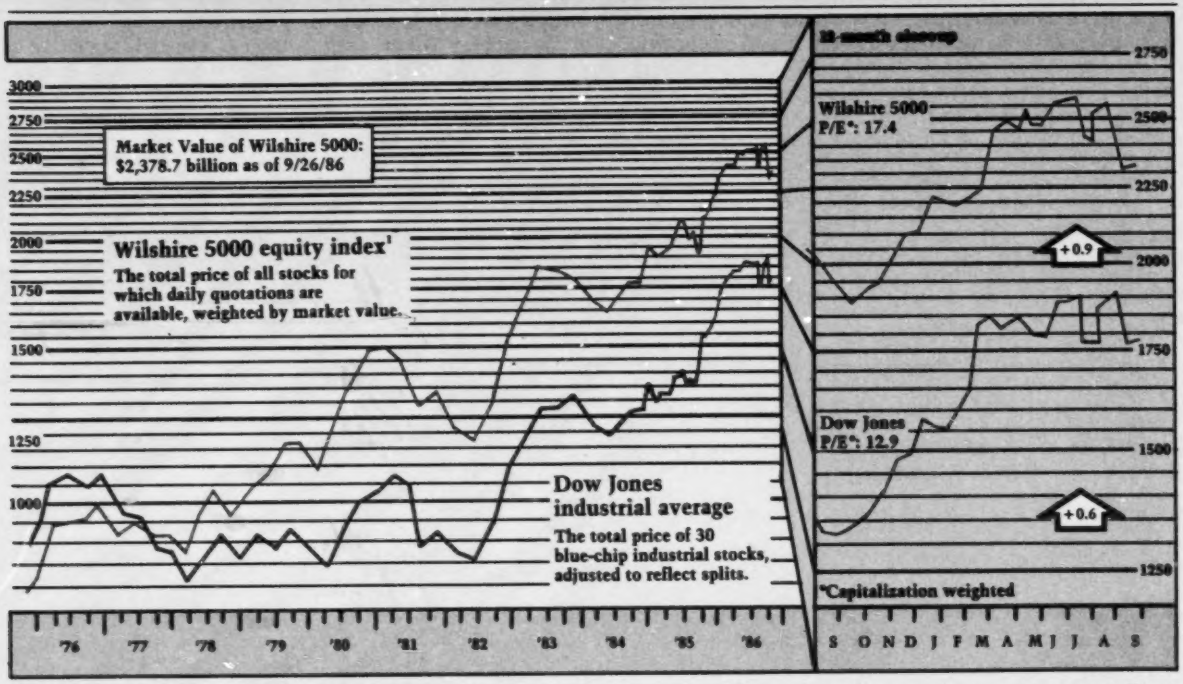
In theory, that may be a good point. But where, in practice, do you draw the line? What costs are associated with which loans? Advertising mortgage rates is obviously a cost of doing business, but it's unlikely that the FASB will permit advertising and other solicitation expenses to be capitalized. Presumably, lenders would also like to capitalize some personnel, data processing, rent and other overhead costs. The FASB will certainly not allow many of these to be capitalized. But expect the accountants to yield some ground on the cost issue by the time the final rules are written in December.

It is useful, if a little depressing, to remember that as accounting rules change, the accountants are almost always a few years behind businessmen intent on bending new rules to their advantage. Listen to Bertill Gustafson, senior vice president of Great Western Financial Corp.: "Some people have been saying, 'Well, we'll originate loans and sell them to Home Savings or whomever, and Home Savings can originate loans and sell them to Great Western or whomever. Then we would all be able to take income on the fees.' "

Far from being over, Gustafson is saying, the thrifts' points party is just preparing to move down the hall. ■

The Forbes/Wilshire 5000 Review

Edited by Steve Kichen


Market Value of Wilshire 5000: $2,378.7 billion as of 9/26/86
Wilshire 5000 equity index[1]
The total price of all stocks for which daily quotations are available, weighted by market value.
Dow Jones industrial average
The total price of 30 blue-chip industrial stocks, adjusted to reflect splits.
12-month closeup
Wilshire 5000 P/E*: 17.4
Dow Jones P/E*: 12.9
+0.9
+0.6
*Capitalization weighted
'76 '77 '78 '79 '80 '81 '82 '83 '84 '85 '86
S O N D J F M A M J J A S

The stuff of bad dreams. Investors began to buy stocks again after the sharp correction in mid-September, but without much spirit. The buying fervor that existed after earlier, but less severe, market setbacks was just not present. The Dow eked out a 0.6% advance over the last two weeks. On a point basis the Dow's gain is less than 11 points, or just a few minutes' worth of volatility on one of the Dow's more torrid days.

The classic caution about the dangers of projecting the future from the past is always relevant. It's especially so now. Over the last 52 weeks the Wilshire index shows a 27% gain, while the Dow is up 34%. If this torrid pace were to continue, the Dow would be priced at 2370 one year from now. But a continuation of the bull market, even at a much more modest pace, would have to come in the face of new declines in earnings estimates, the budget deficit and the balance of trade problem. These are not the stuff that dreams of fast profits are made on.

Closeup On The Equity Markets

Performance of six leading indexes

Percent change	Wilshire 5000	Forbes 500[2]	Dow Jones industrials	NYSE Composite	Amex Market Value Index	NASDAQ Composite
in last 4 weeks	–7.8	–8.4	–6.8	–7.8	–4.3	–8.2
in last 52 weeks	27.0	23.8	34.0	27.8	18.1	25.5

Stock performance based on six key investor yardsticks

Percent change	Company size		Volatility[3]		P/E multiple		Dividend yield		Growth profile[4]		Share price	
	large	small	high	low	over 25	under 5	over 7.5%	none	high	low	over $40	under $4
in last 4 weeks	–7.3	–4.1	–2.8	–4.2	–6.3	–5.0	–4.9	–3.6	–3.2	–5.5	–7.1	–4.3
in last 52 weeks	31.0	41.5	62.3	34.1	20.8	38.4	28.6	42.5	57.4	40.1	39.4	26.6

[1]Wilshire index reflects price performance. It differs slightly from market value of outstanding stocks because of retirements of equity since index was created.
[2]Based on sales.
[3]A stock's sensitivity to overall market movement. High-volatility issues have wide price fluctuations, low-volatility issues are more stable.
[4]A quantitative evaluation of a stock's growth image, determined by Wilshire Associates.

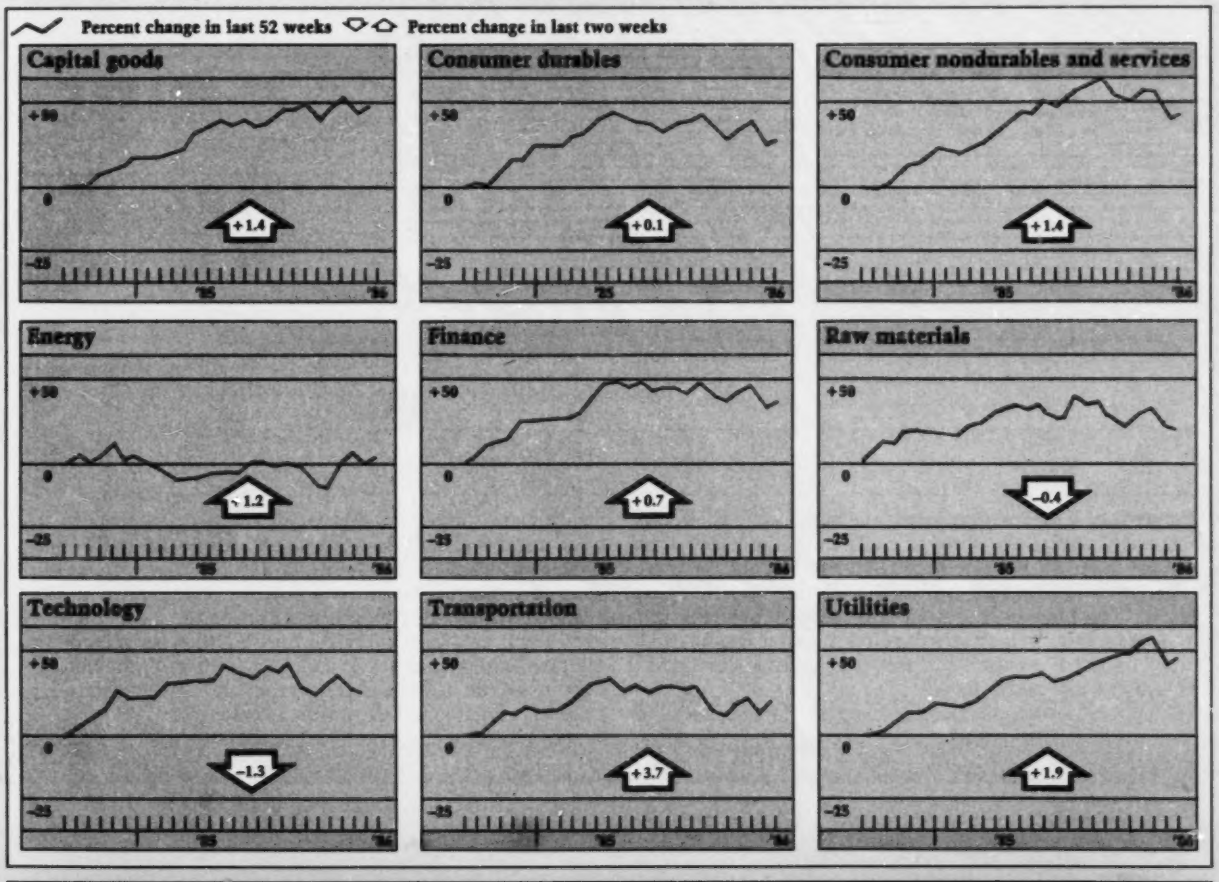
Note: All data for periods ending 9/26/86. Prepared by Wilshire Associates, Santa Monica, Calif.

Gay French

Where The Action Is

Hot and cold spots. Transportation stocks, up 3.7%, far outgained the Wilshire index as a whole, up 0.9%, in the last two weeks. Overnite Transportation, a Virginia-based common motor carrier, rose almost 32% on a tender offer from Union Pacific. Texas Air, which agreed to buy People Express, was up nearly 25%. The purchase, along with the pending acquisition of Eastern Air Lines, would make Texas Air the largest U.S. airline holding company. And Trans World Airlines, which has more than doubled in the last 52 weeks, registered a 24% gain.

Technology shares posted the largest two-week loss. Hewlett-Packard fell 15%. The firm announced it was delaying the release of a new computer. The only other sector to lose ground was raw materials. The worst issue in this group was Dome Mines, the Toronto-based gold producer, which fell 20%.



What The Analysts Think

On the wrong track. A strong upward revision in the 1986 earnings forecast for PSA was not large enough to stem the overall decline in estimates for the transportation sector. Reason: Analysts made double-digit estimate cuts for two railroads, Kansas City Southern and Union Pacific, and also reduced the forecasts of a number of regional airlines.

Forecasting the Forbes 500

Performance period	Average earnings per share	P/E
latest 12 months	$2.70	15.7
1986 estimates	3.28	12.9
1987 estimates	3.90	10.9

Rank based on change in estimate	Sector	Estimated 1986 EPS	Estimated 1986 P/E	% change in 1986 estimate in 2 weeks	% change in 1986 estimate in 4 weeks
1	Finance	$3.24	10.7	-0.14%	-1.09%
2	Consumer nondurables	2.08	15.7	-0.34	-0.68
3	Utilities	3.27	10.4	-0.35	-0.60
4	Consumer durables	3.02	10.3	-0.49	-0.88
5	Technology	2.54	14.1	-0.74	-1.32
6	Raw materials	1.80	16.6	-1.81	-3.14
7	Capital goods	2.32	16.0	-1.86	-3.67
8	Energy	2.06	15.3	-2.02	-4.54
9	Transportation	1.48	18.2	-2.30	-7.60

Earnings projections are capitalization-weighted consensus estimates from over 2,000 security analysts. Data are compiled and updated continuously by the Institutional Brokers Estimate System (IBES), a service of Lynch, Jones & Ryan, a New York-based brokerage firm.

Note: All data for periods ending 9/26/86. Prepared by Wilshire Associates, Santa Monica, Calif.; IBES, a service of Lynch, Jones & Ryan, New York.

Business is still so bad for the oilfield service industry that you can almost hear bold contrarians saying, "Aha!"

Looking beyond the bad news

By Matthew Schifrin

SINCE THE START OF 1985, falling stock prices have cut the market value of 20 prominent oilfield stocks by over $12 billion—a 46% drop. Two major firms, Smith International and Global Marine, are bankrupt. Gearhart, Zapata, Western Co. of North America and Reading & Bates are all in severe financial distress. The *Value Line Investment Survey*, gauging the attractiveness of the oilfield service group right now, ranks it 90th on a list of 92. (The 91st and 92nd are silver and oil production.)

Despite the bad news—or because of it—this industry has attracted the likes of Robert Torray, Batterymarch Financial Management, Irwin Jacobs and Harold Simmons. In August the

Searching for survivors

The price the oilfield service industry has paid for being in the doghouse for the last five years is all too plain in the statistics below. The immediate future for these companies is not much better than the present, which could scarcely be grimmer. But patient investors—with a strong stomach—just might find some bargains here.

Company	Price recent	Price 52-week high–low	EPS latest 12 mos	Current ratio	Price/ sales 1986 est	Cash flow/ int exp 1986 est	Long-term debt (mil)	Equity (mil)	Market cap (mil)	Sales 1985 (mil)
Baker Intl	10	18⅛– 8⅞	$–4.49	2.4	0.58	1.3	$377	$1,010	$701	$1,904
Camco	15⅜	18¾–12½	1.28	2.9	0.92	6.5	12	102	113	175
Cameron Iron Works	9⅞	14½– 9⅛	0.15	2.2	0.67	0.7	169	343	299	547
Daniel Industries	6⅜	8⅝– 6	–0.13	3.6	0.73	1.6	13	93	65	138
Dresser Industries	18	19¾–14	–2.74	1.9	0.37	7.8	384	1,646	1,381	4,111
Enterra	6	12⅞– 5	–1.13	2.1	0.63	4.8	48	123	54	142
GEO International	2⅛	4 – 1¾	–2.49	2.9	0.30	NM	9	94	30	244
Gearhart Inds	1⅜	9 – ⅞	–9.18	0.8	0.13	NM	230	124	44	674
Global Marine	1	2 – ¾	–9.51	0.1	0.17	NM	1,269	291	33	379
Halliburton	22⅛	28⅜–17⅜	–3.73	2.1	0.84	20.0	443	2,858	2,341	4,779
Helmerich & Payne	21	24½–16⅞	0.45	4.6	4.40	6.3	85	428	528	192
Hughes Tool	7⅝	13⅜– 6¾	–1.04	3.1	0.59	NM	336	938	426	1,261
Kaneb Services	2⅞	8⅝– 2¼	–4.41	1.7	0.84	0.7	156	360	84	179
McDermott Intl	20½	23⅜–13⅜	6.84	1.0	0.31	40.0	913	1,204	758	3,257
NL Industries	4¾	5⅛– 3⅜	–4.76	1.4	0.50	3.3	237	786	297	1,423
Noble Drilling	2¼	4½– 1½	1.46	2.0	0.85	NM	28	115	25	72
Ocean Drill & Exp	12⅛	22 –10⅝	–0.35	1.6	2.08	3.8	189	840	624	634
Parker Drilling	3½	5⅛– 2⅞	–2.02	2.7	0.70	NM	239	223	106	255
Reading & Bates	1⅞	6⅞– 1¼	–8.33	1.4	0.35	NM	449	219	52	237
Rowan Cos	4½	8⅝– 3¾	–0.24	2.5	1.75	NM	135	579	245	273
Schlumberger	33¾	37⅜–27¼	0.15	2.0	2.17	4.0	987	6,877	9,773	6,119
Smith Intl	2⅜	8⅜– 1⅛	–11.23	NM	0.17	NM	481	183	60	697
Tidewater	4¾	16⅛– 4¼	–2.06	1.7	0.69	NM	176	249	104	238
Western Co No Amer	1	4⅞– ¾	–3.62	0.3	0.23	NM	56	335	47	500
Zapata	3⅜	9½– 3¼	–7.84	1.5	0.46	NM	602	391	70	289

NM: Not meaningful.

Sources: Disclosure II via MicroScan Data on diskette from Lotus Information Services; Forbes.

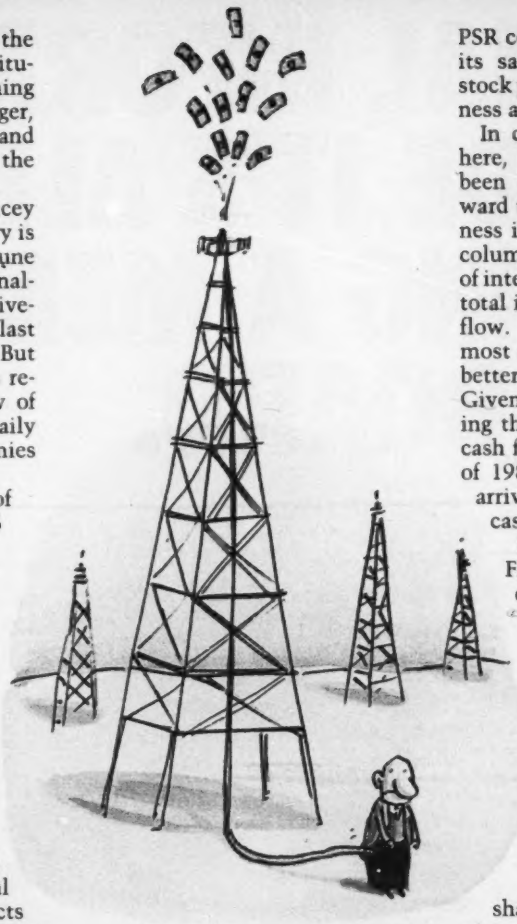
group rose 19%, vs. a 7% gain in the Wilshire index, a sign that institutional bottom-fishers are becoming active. Halliburton, Schlumberger, Ocean Drilling & Exploration and Baker International were among the strongest gainers.

But these stocks remain a dicey play. Solid evidence that a recovery is at hand is thin. It's true that in June the industry's onshore-rig count finally bottomed out at 588, ending a five-year drop from 4,600 in 1981. At last count, 684 rigs were operating. But that's only 26% of the industry's reduced capacity of 2,600, and few of these are profitable at current daily rates. Revenues for most companies are still declining.

The key to better times, of course, is higher prices. Oil at $15 a barrel gives little incentive to boost exploration efforts. But even a slight increase in business would help the oilfield service industry.

If you think that's likely, listen up. Our computer gave us an initial list of oilfield companies with 1985 sales of at least $70 million and share prices greater than $1. Many of the 25 companies on our final list are still losing money, and Wall Street, as indicated by earnings forecasts from the Institutional Brokers Estimate System, expects little improvement before 1988. Remember, too, that with several thousand rigs sitting idle, book values right now are surely higher than salvage values.

One yardstick that can help evaluate these companies is the price-to-sales ratio, or PSR. The PSR shows how much investors are ready to pay for a dollar of a company's sales. Back in the last boom year, 1981, oilfield stocks sold on average at 1.42 times their sales. More than half the companies in the table opposite have PSRs under 0.75. Ken Fisher, the money manager, FORBES columnist and a proponent of PSRs, argues that if a low-PSR company can hold on to most of its sales in lean times, significant stock price gains are likely when business and margins improve.



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In calculating price-to-sales ratios here, estimated sales for 1986 have been conservatively adjusted downward to reflect continuing poor business in the second half of 1986. The column headed "Cash flow coverage of interest expense" shows the ratio of total interest expense to current cash flow. It's a key datum—companies most capable of covering debt have a better chance of outlasting the slump. Given the sharp drop in oil prices during the last year, we have taken the cash flow from the first two quarters of 1986 and multiplied it by 1.5 to arrive at a reasonable estimate of cash flow for the year.

Suzanne Cook, an analyst with First Boston, thinks Dresser Industries looks good. Dresser Chairman John Murphy aggressively cut back his oilfield operations and sold divisions. The restructuring has thus far raised $300 million in cash, and the company recently announced plans to buy back up to 15% of its stock over the next 18 months. Cook also likes McDermott's common and preferred.

The table below lists preferred shares of some major oilfield service companies. The lure of preferreds lies in their present yields, potential yields and the seniority of these shares to common stock. More companies may have to restructure or file for bankruptcy, so the seniority of preferred stock could be crucial. Half the preferred issues have cumulative dividends in arrears. ■

A preference for preferreds

Below are eight issues of preferred stocks for six companies in the oilfield services industry. Half of the companies on the list already have stopped paying dividends. Investors may want to investigate these anyway. When ailing companies restructure, they often offer preferred holders attractive payoffs.

Company	Issue	S&P's rating	Recent price	Stated annual dividend	Yield	Amount in arrears per share	Conversion —into common— rate	Conversion —into common— value	Recent common price
Global Marine	$3.50 cum conv	D	3	$3.50	NA	$4.37	2	$2.00	1
Kaneb Svcs	adj rate cum-A	B	75	v	10.4%	NA	NA	NA	2⅛
McDermott Intl	$2.20 cum-A	BBB	26	2.20	8.5	NA	1	20.50	20½
McDermott Intl	$2.60 cum-B	BBB	26⅛	2.60	9.9	NA	NA	NA	20½
Reading & Bates	$2.13 cum conv	C	5⅞	2.13	NA	1.06	1.3	2.44	1⅞
Reading & Bates	adj rate cum	C	4⅜	v	NA	1.10	NA	NA	1⅞
Tidewater	6% adj conv	B+	87½	v	6.9	NA	14	66.50	4¾
Western Co No Amer	$7.25 cum-A	D	4½	7.25	NA	3.63	NA	NA	1

NA: Not applicable; v: Variable, depending on rates.

Source: FORBES